

SIGNED.

Dated: January 27, 2012



James M. Marlar

James M. Marlar, Chief Bankruptcy Judge

**UNITED STATES BANKRUPTCY COURT
DISTRICT OF ARIZONA**

In re:

KAUFMAN PEBBLE CREEK, LLC,

Debtor.

Chapter 11

No. 4:10-bk-32879-JMM

MEMORANDUM DECISION

On January 11, 2012, this court heard evidence concerning the fair market value of the Debtor entity's apartment complex. This hearing was necessary in order to establish value, for purposes of formulating a reorganization plan and assessing its feasibility in light of the valuation. 11 U.S.C. § 506.

This is an involuntary case, filed October 13, 2010, by a group of creditors. The real property at issue is a 107-unit apartment complex located at 7001 East Golf Links Road in Tucson, Arizona.

Evidence was presented by both the secured creditor, City National Bank, which holds a senior lien on the property of close to \$10 million, and by the petitioning creditors. Each side obtained the assistance of competent and reputable appraisers, who testified as to their respective opinions of value, and the methods each used in coming to their ultimate conclusions.

The parties are familiar with the basic facts, and there is no controversy over what is being dealt with. In essence, the apartments are not even 50% occupied at present, and substantial work needs to be done to bring the property up to higher, and "stabilized"

1 occupancy levels. The complex was originally built in 1973, and was extensively remodeled in
2 2007-2008.

3 The complex sits in an area which has a plethora of other apartments, and thus is
4 surrounded by competition for available renters.

5 Both appraisers are well-known to the court, and both have sterling reputations. Had the
6 two conferred prior to the hearing, this court has no doubt that they could have arrived at a
7 valuation figure that both could agree on.

8 For the creditor-proponents, Steven R. Cole's appraisal report (Ex. A) had an effective
9 date of August 24, 2011, and he placed the value of the apartment complex at:

10
11 "As Is" - \$3,600,000
12 Stabilized - \$4,600,000
13

14 At the time of his appraisal, occupancy was at 46%.

15 Richard J. Kalinowski, Jr. testified for the secured creditor, City National. His effective
16 valuation date was November 18, 2011, at which time the occupancy levels had decreased to
17 around 35% (Ex. 1). Mr. Kalinowski's values were:

18
19 "As Is" - \$5,610,000
20 Stabilized - \$5,970,000
21

22 In their discussion about each appraisal, the attorneys prepared a helpful comparison chart of
23 principal points, showing where each appraiser deviated. The chart showed that, except for a
24 few areas--which areas affected their bottom line opinions--the appraisers were in fundamental
25 agreement (Ex. 2). By narrowing the focus of the case in this way, the attorneys were able to
26 more precisely discuss the reasons for the differences with the appraisers. This was of great
27 assistance to the court.

28 The critical differences between the appraisers fall into only 3-4 categories:

- Expenses
 - Utilities
 - Personnel salaries and benefit
 - Contract services
- Capitalization rate
- Rent loss and "Developer's Profit" ("Entrepreneurial Incentive")
- Real estate taxes due

As between these narrow categories, each appraiser had cogent reasons for selecting the mathematical figures chosen. But in candor, each also acknowledged that some numbers were not precise, but that professional judgment had been exercised to attempt to reach the most probable conclusion.

For the court, unburdened by the subtleties of the real estate appraisal profession, the luxury of either choosing between competing appraisals, or attempting further analysis, is the art. Here, respect for the reputations of both appraisers, and their considered judgments, requires a court to attempt to do what it is confident the two appraisers might themselves have done, in a cloistered and collegial conference.

For a court, selection of the appropriate "cap rate," and application of a mathematical formula to accepted numbers, will divine the "value," to the extent it can be achieved without the intervention of the real world, i.e., an actual buyer and an actual seller.

But, that's the task, so we must begin. The mathematical formula, once the figures are established, is not difficult. It is:

Step 1: Net Operating Income (NOI) ÷ Cap Rate = "Stabilized Value"

Step 2: Subtract from "Stabilized Value" various elements, such as rent loss during the "lease up" period (to get to, say, a 90% occupancy), other rehab expenses, etc.

Step 3: "Stabilized Value" minus Step 2 deductions = "As Is Value"

1 The art is in making sure that the NOI figure is as accurate as one can make it, and
2 selecting an acceptable--and probable--cap rate.

3
4 **EFFECTIVE GROSS INCOME**

5
6 Happily, both appraisers were extremely close on the income side of the equation:

7
8 Cole: \$855,863

9 Kalinowski: \$853,099

10
11 For purposes of this analysis, the court will select the slightly lower Kalinowski figure.

12
13 **EXPENSES**

14
15 **Real Estate Taxes and Insurance**

16
17 This part of the analysis requires some intellectual juggling. In attempting to project real
18 estate taxes and insurance, it was noted that each appraiser, using historical figures and then
19 making educated guesses as to what the future would bring, came up with slightly different
20 figures. The court has no difficulty with simply "splitting the difference" there, because
21 exactitude is not possible. Thus, the court finds:

22

	<u>Cole</u>	<u>Kalinowski</u>	<u>Court</u>
23 Real Estate Taxes	\$56,343	\$50,825	<u>\$53,584</u>
24 Insurance	\$29,425	\$26,750	<u>\$28,087</u>

25
26
27
28

1 **Administrative**

2

3 The same arbitrary "analysis" applies to administrative expense:

4

5

	<u>Cole</u>	<u>Kalinowski</u>	<u>Court</u>
6 Administrative	\$12,840	\$13,375	<u>\$13,107</u>

7

8 **Repairs and Maintenance**

9

10 Each appraiser agreed that this figure was \$58,850. The court will adopt it.

11

12 **Off-Site Management and Marketing**

13

14 Again, the numbers were so close, that the "split adjustment" can be employed without

15 doing substantial harm to the overall task:

16

17

	<u>Cole</u>	<u>Kalinowski</u>	<u>Court</u>
18 Off-Site Management	\$29,955	\$34,124	<u>\$32,039</u>
19 Marketing	\$16,050	\$13,375	<u>\$14,712</u>

20

21 **Replacement Reserves**

22

23 Because the appraisers' numbers were so close, these two can also be split:

24

25

	<u>Cole</u>	<u>Kalinowski</u>	<u>Court</u>
26 Replacement Reserves	\$32,100	\$26,750	<u>\$29,425</u>

27

28

1 **Utilities**

2
3 On this issue, the appraisers were a bit apart, with Mr. Cole at \$96,300 and Mr.
4 Kalinowski at \$80,250. The difference is accounted for by the method. Mr. Cole used six
5 months of historical data, and projected the other six, to arrive at his number. Mr. Kalinowski
6 used 12 consecutive historical months.

7 In this category, the court favors the historical approach, and therefore adopts Mr.
8 Kalinowski's figure of \$80,250 for this category.

9
10 **Personnel Salaries and Benefits**

11
12 Here, the appraisers were \$32,100 apart, the difference being explained as either that
13 more rentable units coming on-line requires more personnel (Mr. Cole), versus the point that
14 efficiencies of scale allow a smaller number of workers to manage the complex's 107 units.

15 While it is certainly possible that the accurate number may lie somewhere in between,
16 that exact point could, theoretically, be found at any given point on the scale, and not
17 necessarily at the mid-point.

18 The court therefore favors Mr. Kalinowski's more conservative approach, and will adopt
19 \$85,600 as the figure for this category.

20
21 **Contract Services**

22
23 Mr. Cole utilized a figure of \$37,450 for these types of matters, such as landscaping,
24 termite treatment, pool service and security.

25 Mr. Kalinowski gave no figure for this line item, nothing that he had included it within
26 the "Repairs and Maintenance" category.

27 Since the court views repairs and maintenance as different than contract services, and
28 since Messrs. Cole and Kalinowski used exactly the same number in the "Repairs and

1 Maintenance" category (\$58,850), the court feels that Mr. Cole's views on this item were more
2 persuasive.

3 Hence, for "Contract Services," the court will utilize the figure of \$37,450.

4
5 **THE APPLICABLE CAPITALIZATION RATE ("CAP RATE")**

6
7 The next area of opinion comes in attempting to determine the appropriate "cap rate" to
8 apply to the NOI. The formula is:

9
10
$$\text{NOI} \div \text{Cap Rate} = \text{Stabilized Market Value}$$

11
12 The bottom line of this calculation is to determine the property's value, as if it were
13 "stabilized." This is defined as having paying tenants with an occupancy rate of about 90%.
14 That stability means, to the owner, that it can predictably count on income for the foreseeable
15 future, having stabilized its income and expenses.

16 Cap rates are elusive. Judgment of each appraiser is critical in arriving at that number,
17 because even slight variations can result in differences of thousands, or hundreds of thousands
18 of dollars as to the market value of a property.

19 The cap rate measures risk to an investor. The higher the rate, the higher the risk. Thus,
20 evaluating location, condition, other intangibles such as proximity to necessary services, crime
21 and so forth, all contribute to this evaluation.

22 When attempting to determine cap rates, these appraisers looked at other sales,
23 comparable in some, all, many, or indeed no ways to the subject property, and they then made
24 calculated judgments as to what risk factors they felt contributed to the establishment of a cap
25 rate for the subject property.

26 In Mr. Cole's analysis, he looked at three sales and one listing of other apartment
27 complexes, made adjustments and determined their cap rates to be:

<u>Property</u>	<u>Cap Rate</u>	<u>Sold</u>
Copper Hill Apartments, Tucson	7.25%	08/2011
Casa Bella Apartments, Tucson	7.43%	08/2011
Villa Antigua Apartments, Tucson	8.08%	04/2011
Sherwood Gardens Apartments, Tucson	7.27%	Listing

Mr. Kalinowski used five comparable Tucson sales, and two sales from the Phoenix area, in his attempt to find an appropriate cap rate. For purposes of this opinion, the court will disregard Phoenix, due to the vast geographical and demographical differences between the two cities and their environs. In Tucson, Mr. Kalinowski looked at:

<u>Property</u>	<u>Cap Rate</u>	<u>Sold</u>
Casa Bella Apartments, Tucson	7.43%	08/2011
El Dorado Place, Tucson	7.00%	07/2011
Villa Antigua Apartments, Tucson	4.90% ¹	04/2011
Terra Vida, Tucson	6.47%	05/2010
Retreat at Speedway, Tucson	6.50%	05/2010

From these reviews, each appraiser found the appropriate cap rate for the subject to be:

Mr. Cole	8.00%
Mr. Kalinowski	7.25%

From a review of all the evidence, and consideration for the methodology, the court feels that Mr. Cole's rate is too high, supported by only one sale, and Mr. Kalinowski's is too low, based on the return on investment expected from this particular property. In this current

¹ The court is baffled by the substantial difference between the two appraisers on this same property.

1 market, the court finds and concludes that a willing buyer would negotiate for a cap rate of
2 7.5%

3 This leads, then, to an opinion of stabilized value for the subject property to be:

4
5
$$\text{NOI } (\$419,995) \div 7.5\% = \$5,599,933$$

6

7 The court will round that figure to \$5,600,000.
8

9 **DEDUCTIONS FROM STABILIZED VALUE**
10

11 Each appraiser testified to his opinion of how long it would take to get all the currently
12 unsuitable apartments repaired and on-line, generating revenue, and how much it would cost to
13 get them there. Each included some component for "Developer's Profit" or "Entrepreneurial
14 Incentive." Mr. Cole's "Developer's Profit" figure was simply 10% of the stabilized value. His
15 other figures (rent loss and cost to complete) were more easily understood than Mr.
16 Kalinowski's analysis (which wrapped a Developer's Profit within the rent loss figure, and did
17 not break it out separately).

18 Therefore, on this piece of the puzzle, the court finds the appropriate numbers to be used
19 are:

20	Rent loss (9 months)	\$ 126,921
21	Cost to complete	\$ 401,833
22	Developer's Profit (10% of	
23	stabilized number of \$5.6 million)	<u>\$ 560,000</u>
24	TOTAL	\$1,088,754

25

26 Both sides conceded that, from this final figure, an additional amount would have to be
27 subtracted in order to account for any unpaid real property taxes. Once the parties have
28 established that figure with accuracy (and there should be no debate over it, since the County

1 Assessor will provide the "cure" number), then those taxes would be an additional deduction
2 from the "as is" number.

3 **CONCLUSION**

4
5 For § 506 valuation purposes, the court finds and concludes that the "as is" value of the
6 subject 107-unit apartment complex is:

7
8 \$4,511,246

9 Less: (Past Due Taxes)

10
11 The court's calculations are summarized in the attached Exhibit "A" to this Memorandum
12 Decision. A separate order will be entered. FED. R. BANKR. P. 9021.

13
14 DATED AND SIGNED ABOVE.

15
16 COPIES to be sent by the Bankruptcy Noticing
Center ("BNC") to the following:

17 Sally M. Darcy, Attorney for Petitioning Creditors
18 James B. Ball, Attorney for City National Bank
19 Office of the U.S. Trustee
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23
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26
27
28

EXHIBIT "A"
Court's Calculation of "As Is" Fair Market Value

Effective Gross Income	<u>853,099</u>
Expenses	
• Real Estate Taxes	53,584
• Insurance	28,087
• Utilities	80,250
• Administrative	13,107
• Repairs and Maintenance	58,850
• Personnel Salaries and Benefits	85,600
• Contract Services	37,450
• Off-Site Management	32,039
• Marketing	14,712
Subtotal (Expenses)	403,679
• Replacement Reserves	29,425
Total Expenses	<u>433,104</u>
• Per Unit	4,047
Net Operating Income	419,995
Overall Cap Rate	7.5%
Reconciled as if Stabilized Value	5,600,000
Deductions from "As Is" Stabilized Value	
• Rent Loss	126,921
• Cost to Complete	401,833
• Developer's Profit	560,000
Total Deductions	<u>1,088,754</u>
AS IS VALUE CONCLUSION	4,511,246
<u>LESS:</u> Past Due Real Property Taxes	